

Report  
of the  
Examination of  
Southern Life and Health Insurance Company  
Birmingham, Alabama  
As of December 31, 2002

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# State of Wisconsin / OFFICE OF THE COMMISSIONER OF INSURANCE

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February 19, 2004

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Commissioners:

In accordance with the instructions of the Wisconsin Commissioner of Insurance, a  
compliance examination has been made of the affairs and financial condition of:

SOUTHERN LIFE AND HEALTH INSURANCE COMPANY  
BIRMINGHAM, ALABAMA

and this report is respectfully submitted.

## I. INTRODUCTION

The previous examination of Southern Life and Health Insurance Company (SLH) was conducted in 1998 as of December 31, 1997. The current examination covered the intervening period ending December 31, 2002, and included a review of such 2003 transactions as deemed necessary to complete the examination.

The examination consisted of a review of all major phases of the company's operations, and included the following areas:

- History
- Management and Control
- Corporate Records
- Conflict of Interest
- Fidelity Bonds and Other Insurance
- Employees' Welfare and Pension Plans

Territory and Plan of Operations  
Affiliated Companies  
Growth of Company  
Reinsurance  
Financial Statements  
Accounts and Records  
Data Processing

Emphasis was placed on the audit of those areas of the company's operations accorded a high priority by the examiner-in-charge when planning the examination. Special attention was given to the action taken by the company to satisfy the recommendations and comments made in the previous examination report.

The section of this report titled "Summary of Examination Results" contains comments and elaboration on those areas where adverse findings were noted or where unusual situations existed. Comments on the remaining areas of the company's operations are contained in the examination work papers.

The company is annually audited by an independent public accounting firm as prescribed by s. Ins 50.05, Wis. Adm. Code. An integral part of this compliance examination was the review of the independent accountant's work papers. Based on the results of the review of these work papers, alternative or additional examination steps deemed necessary for the completion of this examination were performed. The examination work papers contain documentation with respect to the alternative or additional examination steps performed during the course of the examination.

## II. HISTORY AND PLAN OF OPERATION

SLH was incorporated in the State of Alabama in 1890. In 1981, the company merged with Standard Security Insurance Company and redomesticated to Delaware. As a result of the merger, SLH became a wholly owned subsidiary of Geneve Capital Group, Inc., now called Honor Capital Corp. The ultimate parent of the group is Geneve Holdings, Incorporated, which is more than 50% owned by Mr. Edward Netter and his family. In 1995, the company changed its state of domicile to Wisconsin.

SLH had historically concentrated on writing individual home service life, disability, and hospitalization policies. Effective March 1, 1992, the company sold all of its premium-paying business, other than annuities, to United Insurance Company of America (United). United then transferred all Louisiana policies from the block to its affiliate, Union National Life Insurance Company (Union National). Effective December 31, 1992, SLH entered into a co-insurance agreement with Union National, under which SLH assumed 100% of Union National's extended term and paid-up life insurance policies in Louisiana. Effective December 27, 1993, the company entered into a coinsurance agreement with United, under which SLH assumed a block of paid-up and extended term life insurance. With these two assumptions, SLH agreed to co-insure policies that become paid-up or extended term through nonforfeiture election (with some coming from the block that SLH had originally written), while United and Union National continued to insure the premium-paying business.

The company is licensed in the following states.

Alabama  
Delaware  
Florida  
Louisiana  
Mississippi  
Texas  
Wisconsin

In 2002, the company collected direct premium in the following states:

Alabama	\$ 1,278	9.2%
Florida	12,300	88.6
Texas	<u>300</u>	<u>2.2</u>
Total	<u>\$ 13,878</u>	<u>100.0%</u>

At present, SLH is not marketing any new direct business. The small amount of direct annuity business reported by the company is the result of considerations received on flexible premium annuities. SLH's current business consists mostly of direct and assumed policies that have become paid-up or extended term through nonforfeiture election.

The following chart is a summary of the premium income reported by the company in 2002. The growth of the company is discussed in the Financial Data section of this report.

#### Premium Income

<b>Line of Business</b>	<b>Direct Premium</b>	<b>Reinsurance Assumed</b>	<b>Reinsurance Ceded</b>	<b>Net Premium</b>
Industrial life	\$ 0	\$ 212,682	\$ 0	\$ 212,682
Ordinary life	0	4,417,663	0	4,417,663
Individual annuities	13,878		0	13,878
Total All Lines	<u>\$13,878</u>	<u>\$4,630,345</u>	<u>\$ 0</u>	<u>\$4,644,223</u>

### III. MANAGEMENT AND CONTROL

#### Board of Directors

The board of directors consists of four members. All directors are elected annually to serve a one-year term. Officers are elected at the board's annual meeting. Members of the company's board of directors may also be members of other boards of directors in the holding company group. The board members currently do not receive any compensation for serving on the board.

Currently, the board of directors consists of the following persons:

<b>Name and Residence</b>	<b>Principal Occupation</b>	<b>Term Expires</b>
Edward Netter Greenwich, CT	Chairman and Chief Executive Officer Geneve Corporation	2004
Steven Lapin Stamford, CT	President and Chief Operating Officer Geneve Corporation	2004
Roy Thung White Plains, NY	Executive Vice President Geneve Corporation	2004
Larry Graber Austin, TX	President SLH & Madison National Life	2004

### Officers of the Company

The officers serving at the time of this examination are as follows:

<b>Name</b>	<b>Office</b>	<b>2002 Compensation</b>
Larry R. Graber	President	\$369,995 <sup>a</sup>
H. William Smith	Secretary	98,031 <sup>b</sup>
Donna C. Nelson	Treasurer	82,553

<sup>a</sup> Compensation is paid by Madison National Life Insurance Company (MNL) and SLH reimburses MNL through a cost allocation for the amount allocated to SLH

<sup>b</sup> Salary is paid by Geneve Corporation. SLH currently pays Geneve Corporation \$125,000/quarter under the terms of a management services agreement.

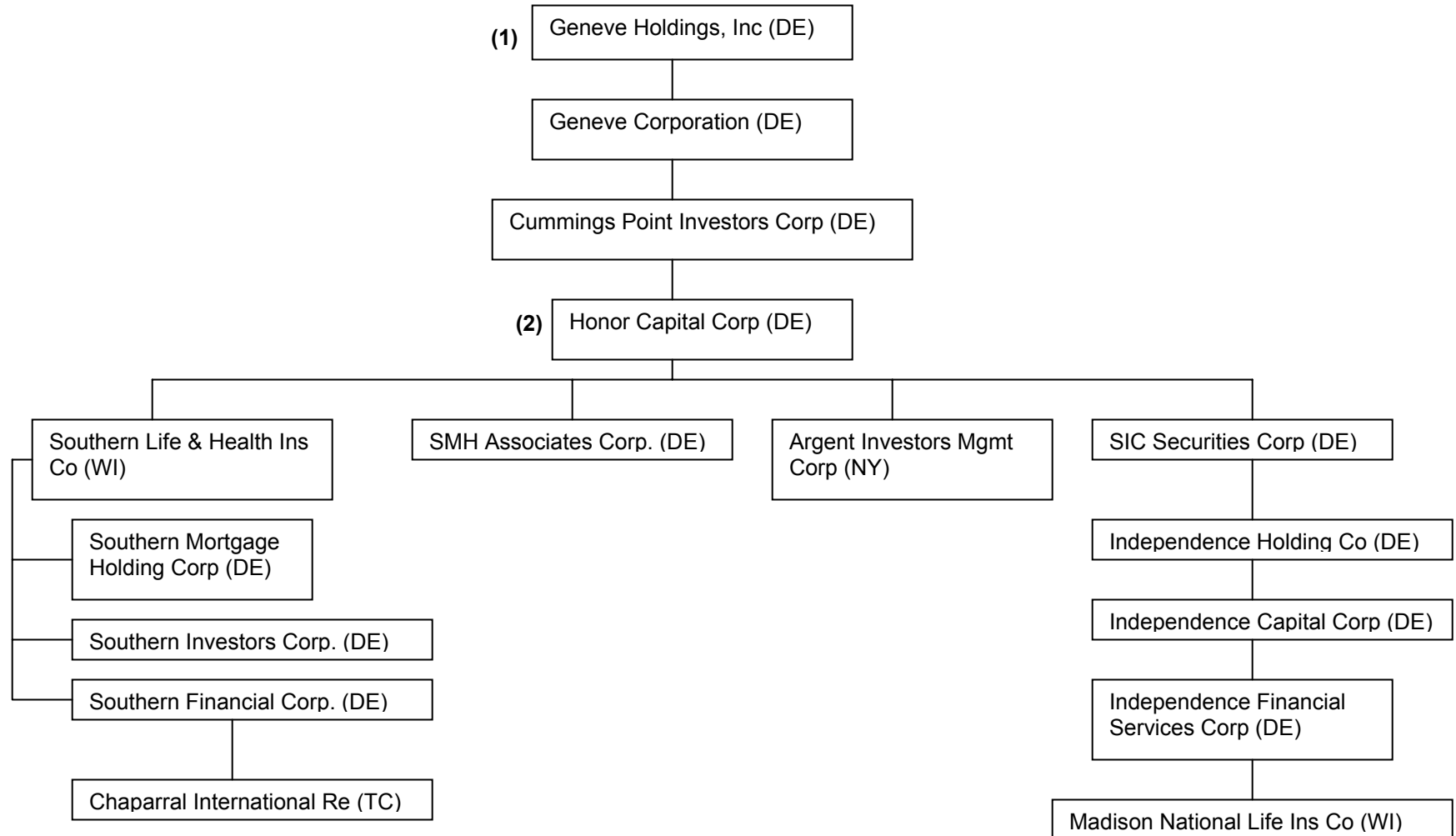
### Committees of the Board

The company's bylaws allow for the formation of certain committees by the board of directors. At the time of the examination there were no board appointed committees.

#### **IV. AFFILIATED COMPANIES**

SLH is a member of a holding company system. The organizational chart below depicts the relationships among the affiliates in the group. A brief description of affiliates deemed significant follows the organizational chart.

**Organizational Chart  
As of December 31, 2002**



1. Mr. Edward Netter and his family own more than 50% of the voting stock of Geneve Holdings.
2. Cummings Point Investors owns 51.4%, Geneve owns 40.8%, and Cason Financial Services (not shown) owns 7.8% of the voting stock of Honor Capital Corporation.

**Geneve Holdings, Inc. (GHI)**

GHI is the ultimate parent of SLH and the owner of a large diversified holding company system whose products and services include the retail distribution of educational health and agricultural products, and financial services and insurance.

**Southern Financial Corp. (SFC)**

SFC is a financial holding company that owns Chaparral International Re (Chaparral), an offshore property and casualty reinsurance company. As of December 31, 2002, SFC's consolidated audited financial statement reported assets of \$7,633,736, liabilities of \$6,407,916, and stockholders' equity of \$1,225,820. Operations for 2002 produced net income of \$37,870.

**Southern Investors Corp. (SIC)**

SIC is a financial holding company that invests its own funds in various ventures. SLH provides administrative services to SIC. As of December 31, 2002, SIC's audited financial statement reported assets of \$39,598,356, liabilities of (\$48,694) and stockholders' equity of \$39,647,050. Operations for 2002 produced net income of \$1,543,240.

**Southern Mortgage Holding Corp. (SMH)**

SMH is a financial holding company that owns a mortgage servicing company. As of December 31, 2002, SMH's audited consolidated financial statement reported assets of \$39,048,368 liabilities of \$1,240,129, and stockholders' equity of \$37,808,239. Operations for 2002 produced net income of \$1,644,912.

**Madison National Life Insurance Company (MNL)**

MNL is a Wisconsin-domiciled life insurer engaged in providing group and credit insurance products, and acquiring blocks of business from other insurers. Major products marketed by MNL include group disability, group term life, credit disability, and credit life insurance.

Although their operations are separate, SLH and MNL share two officers, and SLH uses MNL's home office as its statutory home office. SLH and MNL have executed a cost allocation agreement and a service agreement which are described below in "Agreements with Affiliates".

As of December 31, 2002, MNL's annual statement, as filed with the Office of the Commissioner of Insurance (OCI), reported assets of \$448,219,001, liabilities of \$360,618,165, and capital and surplus of \$87,600,836. Operations for 2002 produced net income of \$147,827.

#### **Agreements with Affiliates**

Southern Life & Health and Geneve Corporation have entered into a management services agreement. Under the agreement, Geneve provides advice and counsel on accounting practices and procedures and on tax returns, legal matters, tax planning, and general business matters. The fee for these services is \$125,000 per quarter. SLH also has an investment counsel agreement with Argent Investors Management Corp., a subsidiary of Geneve Holdings, Inc. The fee for this service is .45% of the mean value of the investment portfolio assets as determined following the end of each fiscal year.

SLH and Honor Capital Corporation (the direct parent of SLH) have a tax-sharing agreement whereby both companies are included in the consolidated tax filing system of the GHI group.

SLH has a cost-allocation agreement and a service agreement with MNL. The cost-allocation agreement exists so MNL and SLH can share certain personnel, facilities, and/or systems for the benefit of both companies. Each party bills the other quarterly for its share of the allocated costs. Services provided under the service agreement between SLH and MNL are legal, marketing, management consulting, policy administration, and accounting. All services are provided at cost and contain no profit.

SLH has administrative service agreements with its subsidiaries (SIC and SMH) to provide consulting, administrative, general management, accounting and other services for \$50,000 per year for each subsidiary. SLH also provides administrative services through a similar agreement with Incopoint (a limited partnership) for \$25,000 a year and Chaparral for \$50,000 a year.

## **V. REINSURANCE**

The company's reinsurance portfolio and strategy are described below. A list of the companies that have a significant amount of reinsurance in force at the time of the examination follows. The contracts contained proper insolvency provisions.

### **Reinsurance Contracts**

SLH entered into a coinsurance agreement with Variable Annuity Life Insurance Company, on December 30, 1982, where SLH assumed a certain block of group annuity business. At the same time, SLH entered into a Retrocession Agreement with Life and Casualty Insurance Company of Tennessee (now known as American General Life and Accident Insurance Company), where SLH retroceded 99% of the block of group annuity business.

In March of 1992, SLH sold its entire premium paying life and accident and health business to United Insurance Company of America. SLH kept its extended term and paid-up life business. The business the company sold was written in Louisiana, Alabama, Florida, Mississippi, and Texas. In December of 1992, the United Insurance Company of America sold the Louisiana and Mississippi portion of the business to their subsidiary, Union National Life Insurance Company.

On December 31, 1992, SLH entered into a coinsurance agreement with Union National Life Insurance Company where SLH assumed all life extended term and paid-up business issued to Louisiana residents. A similar coinsurance agreement was entered into on December 27, 1993, with United Insurance Company of America where SLH assumed all extended term and paid-up life business, originally issued by SLH, to Alabama, Florida, and Texas residents. Both of the coinsurance agreements require the ceding companies to do all the accounting and administrative services for the ceded business.

## **VI. FINANCIAL DATA**

The following financial statements reflect the financial condition of the company as reported to the Commissioner of Insurance in the December 31, 2002, annual statement. Also included in this section are schedules which reflect the growth of the company, NAIC Insurance Regulatory Information System (IRIS) ratio results for the period under examination, and the compulsory and security surplus calculation. Adjustments made as a result of the examination are noted at the end of this section captioned "Reconciliation of Surplus per Examination."

**Southern Life and Health Insurance Company**  
**Assets**  
**As of December 31, 2002**

	<b>Assets</b>	<b>Nonadmitted Assets</b>	<b>Net Admitted Assets</b>
Bonds	\$ 60,460,130		\$ 60,460,130
Stocks:			
Preferred stocks	1,482,920		1,482,920
Common stocks	53,152,410		53,152,410
Real estate:			
Held for production of income	1,845,833		1,845,833
Policy loans	275,456	\$ 78	275,378
Cash	167,070		167,070
Short-term investments	17,420,097		17,420,097
Other invested assets	7,657,385		7,657,385
Receivable for securities	63,614		63,614
Electronic data processing equipment and software	19,030	5,781	13,249
Federal and foreign income tax recoverable and interest thereon	2,354,899	2,109,741	245,158
Investment income due and accrued	672,850		672,850
Receivable from parent, subsidiaries and affiliates	204,736		204,736
Other assets nonadmitted:			
Furniture and equipment	40,493	40,493	
Write-ins for other than invested assets:			
Reserves receivable on reinsurance assumed	<u>3,423,369</u>	<u>          </u>	<u>3,423,369</u>
Total Assets	<u>\$149,240,292</u>	<u>\$2,156,093</u>	<u>\$147,084,199</u>

**Southern Life and Health Insurance Company**  
**Liabilities, Surplus, and Other Funds**  
**As of December 31, 2002**

Aggregate reserve for life policies and contracts		\$ 77,323,007
Contract claims:		
Life		1,422,334
Commissions and expense allowances payable on reinsurance assumed		1,509,145
General expenses due or accrued		1,067,376
Taxes, licenses, and fees due or accrued, excluding federal income taxes		87,933
Unearned investment income		7,916
Amounts withheld or retained by company as agent or trustee		276,806
Liability for benefits for employees and agents if not included above		2,839,798
Miscellaneous liabilities:		
Asset valuation reserve		5,138,118
Payable to parent, subsidiaries and affiliates		5,081
Payable for securities		8,357,201
Write-ins for liabilities:		
Deferred Pension Liability		<u>2,803,057</u>
Total Liabilities		100,837,772
Common capital stock	\$ 1,600,000	
Preferred capital stock	3,325,000	
Unassigned funds (surplus)	<u>41,321,427</u>	
Total Capital and Surplus		<u>46,246,427</u>
Total Liabilities, Capital and Surplus		<u>\$147,084,199</u>

**Southern Life and Health Insurance Company**  
**Summary of Operations**  
**For the Year 2002**

Premiums and annuity considerations for life and accident and health contracts		\$ 4,644,223
Net investment income		6,773,785
Amortization of interest maintenance reserve		(314)
Miscellaneous Income		<u>185,039</u>
Total income items		11,602,733
Death benefits	\$2,250,163	
Matured endowments	189,358	
Annuity benefits	1,226,598	
Surrender benefits and withdrawals for life contracts	718,844	
Interest and adjustments on contract or deposit-type contract funds	1,138	
Payments on supplementary contracts with life contingencies	3,116	
Increase in aggregate reserves for life and accident and health contracts	<u>2,618,449</u>	
Subtotal	7,007,666	
Commissions and expense allowances on reinsurance assumed	1,799,639	
General insurance expenses	1,148,694	
Insurance taxes, licenses, and fees excluding federal income taxes	31,180	
Write-in for deductions:		
Increase in Reserves - Employee Benefit	23,904	
Amortization – Deferred Pension Liability	<u>(92,018)</u>	
Total deductions		<u>9,919,065</u>
Net gain before federal income taxes		1,683,668
Federal income taxes incurred (excluding tax on capital gains)		<u>(421,925)</u>
Net gain (loss) from operations after dividends to policyholders and federal income taxes and before realized capital gains or losses		2,105,593
Net realized capital gains or (losses), less capital gains tax		<u>(80,484)</u>
Net Income		<u>\$ 2,025,109</u>

**Southern Life and Health Insurance Company**  
**Cash Flow**  
**For the Year 2002**

Premiums and annuity considerations for life and accident and health contracts			\$ 7,397,461
Net investment income			6,749,681
Miscellaneous Income			<u>85,039</u>
Total			14,232,181
Death benefits	\$ 2,870,391		
Matured endowments	109,916		
Annuity benefits	1,226,932		
Surrender benefits and withdrawals for life contracts	689,965		
Interest and adjustments on contract or deposit-type contract funds	1,138		
Payments on supplementary contracts with life contingencies	<u>3,116</u>		
Subtotal		\$4,901,458	
Commissions and expense allowances on reinsurance assumed	2,195,000		
General insurance expenses	1,188,121		
Insurance taxes, licenses and fees, excluding federal income taxes	<u>34,145</u>		
Subtotal		<u>3,417,266</u>	
Total deductions			<u>8,318,724</u>
Net cash from operations			5,913,457
Proceeds from investments sold, matured, or repaid:			
Bonds	215,307,296		
Stocks	76,799,239		
Other invested assets	4,354,276		
Net gains or (losses) on cash and short-term investments	2,846		
Miscellaneous proceeds	<u>4,196,142</u>		
Total		300,659,799	
Less: Cost of investments acquired (long-term only):			
Bonds	216,211,362		
Stocks	77,332,415		
Miscellaneous applications	<u>5,562,983</u>		
Total investments acquired		299,106,760	
Net increase (or decrease) in policy loans and premium notes		<u>12,833</u>	
Net cash from investments			1,540,206
Cash provided from financing and miscellaneous sources:			
Other cash provided		(1,736,495)	

Cash applied for financing and miscellaneous uses:		
Dividends to stockholders paid	5,002,000	
Other applications	<u>(529,738)</u>	
Total		<u>4,472,262</u>
Net cash from financing and miscellaneous sources		<u>(6,208,757)</u>
<b>Reconciliation</b>		
Net change in cash and short-term investments		1,244,906
Cash and short-term investments, December 31, 2001		<u>16,342,261</u>
Cash and short-term investments, December 31, 2002		<u>\$17,587,167</u>

**Southern Life and Health Insurance Company  
Compulsory and Security Surplus Calculation  
December 31, 2002**

Assets			\$147,084,199
Less security surplus of insurance subsidiaries			1,225,820
Add security surplus excess of insurance subsidiaries			0
Less excess basket clause investments			303,715
Less examination adjustments to surplus			4,391,653
Less liabilities			<u>100,837,772</u>
Adjusted surplus			40,325,239
Annual premium:			
Individual life and health	\$4,630,345		
Factor	<u>15%</u>		
Total		\$694,552	
Greater of 7.5% of consideration or 2% of reserves for annuities and deposit administration funds		<u>257,773</u>	
Compulsory surplus (subject to a \$2,000,000 minimum)			<u>2,000,000</u>
Compulsory surplus excess or (deficit) per examination			<u>\$ 38,325,239</u>
Adjusted surplus (from above)			\$40,325,239
Security surplus: (140% of compulsory surplus, factor reduced 1% for each \$33 million in premium written in excess of \$10 million, with a minimum of 110%)			<u>2,800,000</u>
Security surplus excess or (deficit) per examination			<u>\$ 37,525,239</u>

**Southern Life and Health Insurance Company**  
**Reconciliation and Analysis of Surplus**  
**For the Five-Year Period Ending December 31, 2002**

The following schedule is a reconciliation of total capital and surplus during the period under examination as reported by the company in its filed annual statements:

	2002	2001	2000	1999	1998
Capital and surplus, beginning of year	\$51,808,543	\$50,037,773	\$52,232,926	\$50,577,192	\$47,039,617
Net income	2,025,109	(93,079)	(4,690,243)	7,023,494	6,520,222
Change in net unrealized capital gains or (losses)	(1,135,083)	2,007,719	3,782,228	(607,291)	1,027,390
Change in net deferred income tax	(105,475)	1,067,144			
Change in non-admitted assets and related items	238,331	338,138	302,963	(1,537,991)	484,490
Change in asset valuation reserve	(1,582,998)	(1,549,152)	3,859,899	(1,144,853)	(3,021,277)
Capital changes:					
Paid in			(75)	(75)	(75)
Surplus adjustments:					
Paid in			(749,925)	(749,925)	(749,925)
Dividends to stockholders	(5,002,000)		(4,700,000)	(1,327,625)	(723,250)
Capital and surplus, end of year	<u>\$46,246,427</u>	<u>\$51,808,543</u>	<u>\$50,037,773</u>	<u>\$52,232,926</u>	<u>\$50,577,192</u>

**Southern Life and Health Insurance Company**  
**Insurance Regulatory Information System**  
**For the Five-Year Period Ending December 31, 2002**

The company's NAIC Insurance Regulatory Information System (IRIS) results for the period under examination are summarized below. Unusual IRIS results are denoted with asterisks and discussed below the table.

	Ratio	2002	2001	2000	1999	1998
#1	Net change in capital & surplus	-11%*	4%	-3%	5%	9%
#2	Gross change capital & surplus	-11*	4	-4	3	8
#3	Net income to total income	18	-1*	-99*	46	43
#4	Comm and Exp to Prem and Deposits			Discontinued		
#5	Adequacy of investment income	229	214	-14*	310	343
#6	Non-admitted to admitted assets	1	1	3	4	6
#7	Total real estate & mortgage loans to cash & invested assets	1	1	1	1	0
#8	Total affl investments to capital & surplus	89	89	87	96	89
#9	Surplus relief	-4	-2	-3	-3	-3
#10	Change in premium	-15*	3	21	-1	63*
#11	Change in product mix	0.8	5.1*	3.4	0.6	2.2
#12	Change in asset mix	0.6	0.6	1.3	1.5	0.9
#13	Change in reserving ratio	-24*	20*	6	-13	54*

Ratio No. 1 and Ratio No. 2 review the net change and gross change in capital and surplus. In 2002, the company had a net change in capital and surplus of (\$5,562,116), mainly due to a dividend to stockholders of \$5,002,000. In 2001, the company had a net change in capital and surplus of \$1,770,770. The differences between 2002 and 2001 caused the unusual ratios.

Ratio No. 3 compares net income to total income and realized capital gains or losses. In both 2000 and 2001, the company had net losses of (\$93,079) and (\$4,690,243), respectively, which caused this ratio to be unusual in those years.

Ratio No. 5 compares the net investment income to the increase in reserves from tabular interest. The exceptional results for Ratio No. 5 in 2000 were due to the company having negative investment income. SLH included undistributed loss in subsidiaries of (\$7,712,392) in net investment income, causing it to be negative. Effective January 1, 2001, this practice is not allowed under codification.

The results for Ratio No. 10, Change in Premium, Ratio No. 11, Change in Product Mix, and Ratio No. 13, Change in Reserving Ratio are magnified due to SLH's lack of premium paying policies.

#### **Growth of Southern Life and Health Insurance Company**

<b>Year</b>	<b>Admitted Assets</b>	<b>Liabilities</b>	<b>Surplus</b>
2002	\$147,084,199	\$100,837,772	\$46,246,427
2001	151,337,620	99,529,077	51,808,543
2000	148,353,072	98,315,299	50,037,773
1999	147,887,522	95,654,596	52,232,926
1998	131,728,205	81,151,013	50,577,192
1997	125,989,301	78,949,684	47,039,617

#### **Life Insurance In Force (in thousands)**

<b>Year</b>	<b>Gross Direct And Assumed</b>	<b>Ceded</b>	<b>Net</b>
2002	\$374,436		\$374,436
2001	367,179	\$10	367,169
2000	355,930	10	355,920
1999	324,011	9	324,002
1998	314,415	10	314,405
1997	294,293	10	294,283

The company's surplus increased each year under the examination with the exception of 2002 during which SLH paid a stockholder dividend of \$5,002,000. The admitted assets also increased every year under the examination with the exception of 2002. The liabilities increased each year under the examination. Gross direct and assumed life insurance in-force as well as net life insurance in-force increased each year since the last examination. This is reasonable given the company's plan to assume paid-up and extended term business.

### Reconciliation of Surplus per Examination

The following schedule is a reconciliation of surplus between that reported by the company and as determined by this examination:

Surplus December 31, 2002, per annual statement			\$46,246,427
	<b>Increase</b>	<b>Decrease</b>	
Reserves Receivable on Reinsurance Assumed		\$1,711,000	
Commissions and expense allowances payable on reinsurance assumed	\$391,000		
Real Estate		1,845,833	
Common Stock – Southern Financial Corp	<u>          </u>	<u>1,225,820</u>	
Net increase or (decrease)	<u>\$391,000</u>	<u>\$4,782,653</u>	<u>(4,391,653)</u>
Surplus December 31, 2002, per examination			<u>\$41,854,774</u>

## VII. SUMMARY OF EXAMINATION RESULTS

### Compliance with Prior Examination Report Recommendations

There were five specific comments and recommendations in the previous examination report. Comments and recommendations contained in the last examination report and actions taken by the company are as follows:

1. Holding Company — It is recommended that in future Form B filings, the company include a description of all agreements with affiliates as required by s. Ins 40.15, Wis. Adm. Code. It is further recommended that the company report changes occurring to items on Form B by completing a Form C as required by s. Ins 40.15, Wis. Adm. Code.

Action—Noncompliance, see the summary of current examination results for further information.

2. Invested Assets — It is recommended that the safekeeping agreement be amended to include provisions requiring:
  - a) That the securities are at all times kept separate and apart from the other deposits with the custodian so that at all times they may be identified as belonging solely to SLH.
  - b) That the trust company as custodian is obligated to indemnify the insurance company for any loss of securities of SLH occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.
  - c) That in the event there is a loss of the securities for which the trust company is obligated to indemnify SLH, the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

Action—Compliance

3. Invested Assets — It is recommended that the safekeeping agreement be signed by both parties.

Action—Compliance

4. Other Invested Assets — It is recommended that in future annual statements, the company nonadmit unsecured loans and the accrued interest thereon, as required by the NAIC Accounting Practices and Procedures Manual for Life and Accident and Health Insurance Companies.

Action—No longer applicable, the company no longer has unsecured loans.

5. Annual Statement Reporting — It is recommended that in future annual statements, write-in lines be used only when none of the preprinted lines are appropriate.

Action—Compliance

## **Summary of Current Examination Results**

### **Information Technology Controls**

The company's "Compaq fileserver" and network distribution panel are kept in an open room that also houses a printer and facsimile machine. All employees of the company have access to this room. As the building and company office have no restrictions on outside personnel entering, exposure of the fileserver and network to unauthorized persons exists. It is recommended that the company secure its file server and distribution equipment, by installing and maintaining locked access to the fileserver room.

Passwords are not required to be changed by the system, or by any company procedures. It is recommended that the company initiate system and/or application changes that force all passwords to be changed at least quarterly.

Although no such sensitive software utilities exist on the company's systems, blank check stock, which constitutes a potentially valuable asset, is kept in an unlocked cabinet, in an unlocked room. It is recommended that the company establish inventory control on its blank check stock, including maintaining a locked cabinet in which to keep the check stock.

The company has no formal emergency response procedures to follow if a computer security incident occurs. It is recommended that the company develop emergency response procedures that at a minimum include a checklist of the procedures to follow, and the resources to contact, in the event of a computer security incident.

### **Affiliated Companies**

There is not an affiliated agreement between SFC and SLH. The company pays invoices on behalf of SFC. In return, SFC pays SLH for the cost incurred. There is not an affiliated agreement between SLH Associates LP and SLH. The company provides administrative services for SLH Associates LP for a fee of \$10,000 per year.

The company had no formal written agreements documenting the duties and responsibilities related to these payments/receipts. Signed written agreements help develop and maintain a division of accountability and responsibility. It is recommended that the company develop and execute agreements, that clearly and accurately disclose the nature and details of all

the various transactions amongst affiliates for all services provided and for settlement of any outstanding balances, pursuant to s. 611.61, Wis. Stat.

The company annually files a holding company Registration Statement on Form B as prescribed by s. Ins 40.15, Wis. Adm. Code. The examiners noted that the Form B did not describe all management agreements, service contracts, and cost-sharing agreements. It is again recommended that in future Form B filings, the company include a description of all agreements with affiliates as required by s. Ins 40.15, Wis. Adm. Code.

In 2001, SIC sold its 58% share of Independence Holding Corporation (IHC), which owns MNL among other subsidiaries, to SIC Securities in 2001. This transaction constitutes a change in control of a domestic insurer and a transaction between a domestic insurer and its affiliates. After the sale of the 58% share of Independence Holding Company, MNL was no longer a subsidiary of SLH. Pursuant to s. Ins 40.02, Wis. Adm. Code, when there is a change in control of an insurer a Form A needs to be filed prior to the transaction taking place. SLH violated s. Ins 40.02, Wis. Adm. Code by failing to file advance notification to the commissioner of the transfer of control of its insurance subsidiary. SLH also violated s. 617.11 (1), Wis. Stat., by failing to notify the commissioner of the transfer of control of its insurance subsidiary. It is recommended that the company fully comply with s. Ins 40.02, Wis. Adm. Code, and s. 617.11(1), Wis. Stat., in the future.

Investments involving a domestic insurer and an affiliate whereby the transactions are equal to or exceed the lesser of 2% of the domestic insurer's admitted assets or 10% of policyholder surplus are required to be reported to the commissioner in writing at least 30 days prior to the date the insurer enters into the transactions and are subject to disapproval pursuant to s. Ins 40.04 (2) (a), Wis. Adm. Code. According to documentation reviewed by the examiners, SLH was a limited partner with a general partner that was a related party as described below:

<b>Name</b>	<b>General Partner</b>	<b>Officers of the General Partner</b>
Dolphin L.P.	Dolphin Associates, L.L.C.	Don Netter, Senior Vice President, Geneve Corporation <sup>1</sup>

<sup>1</sup> Mr. Don Netter is the son of Mr. Edward Netter who is the Chairman and Chief Executive Officer of Geneve Holdings, Inc. and a director of SLH.

SLH Associates Limited Partnership and Incopoint Limited Partnership also had general partners that were related parties, however, SLH divested its interest in both of these partnerships in 2002.

Under the terms of the agreements, the management and control of the business and affairs of the partnership rests with the respective general partner. Pursuant to s. 600.03 (13), Wis. Stat., this partnership is under the common control of the holding company system as indicated in the foregoing table. SLH's investment in the partnership exceeded both two percent of assets and 10% of surplus and should have been filed with the Office of the Commissioner of Insurance (OCI) at least 30 days prior to investing in the partnership pursuant to s. Ins 40.04 (2) (a), Wis. Adm. Code. The company violated s. Ins 40.04 (2) (a), Wis. Adm. Code, by failing to provide the commissioner with advance notice of its investment in the Dolphin Limited Partnership. It is recommended that the company file a Form D for all affiliated transactions which are equal to or exceed the lesser of two percent of the insurer's admitted assets or 10% percent of policyholder surplus, at least 30 days prior to entering into the transaction pursuant to s. Ins 40.04 (2) (a), Wis. Adm. Code.

Under s. Ins 40.03 (3) (b), Wis. Adm. Code, Wisconsin domiciled insurers are required to report in their annual holding company registration statements (Form B) the identity and relationship of every member of the insurance holding company system, except affiliates whose total assets are less than the lesser of 0.5% of the total assets of the ultimate controlling person, or \$10,000,000. The examiners noted that the annual holding company registration statements (Form B) filed on behalf of SLH during the period under examination did not include the transaction involving the partnership listed above. The company violated s. Ins 40.03 (3) (b), Wis. Adm. Code, by failing to disclose the investment in the Dolphin Limited Partnership in its Form B annual holding company registration statements for 1998 through 2002. It is recommended that, in the future, the company report all affiliated partnerships on Form B as required by s. Ins 40.03 (3) (c) (1), Wis. Adm. Code.

According to NAIC Annual Statement Instructions – Life, Accident and Health, Schedule Y, Column 8 should include all revenues and expenditures under management

agreements and service contracts, all income tax amounts resulting from intercompany tax-sharing arrangements, all amounts for contracts for services provided by the insurer or purchased by the insurer from other affiliates, and all compensation under agreements with affiliated brokers and reinsurance intermediaries. The company did not include any amounts in Schedule Y, Column 8. It is recommended the company properly complete Column 8 of Schedule Y, according to the NAIC Annual Statement Instructions – Life, Accident and Health by properly including all revenues and expenditures under management and service agreements.

### **Accounts and Records**

A list of names of the entities with which the company's federal income tax return is consolidated needs to be listed in the Note 9 F to the Annual Statement. SLH did not report all the companies included in the consolidated federal income tax return filed in Note 9 F of the 2002 annual statement. It is recommended the company report all entities which are included in its consolidated federal income tax return in Note 9 F of future Annual Statements in accordance with the NAIC Annual Statement Instructions – Life, Accident and Health.

### **Bonds**

The examination noted that SLH held approximately \$2.95 million of private placement bonds at year-end 2002 that were not disclosed as private placements in Schedule D Part 1A, Section 1, column 11. It is recommended that the insurer disclose its private placement bond holdings in Schedule D - Part 1A, as required by the NAIC Annual Statement Instructions – Life, Accident and Health.

### **Custodial Agreements**

SLH has a custodial agreement with the investment firm of Bernard Madoff, which holds common stocks and short term investments for SLH. Pursuant to s. 610.24, Wis. Stat., only banks are allowed to be custodians. Bernard Madoff is not a bank and the company should not be using this firm as a securities custodian. It is recommended that the company discontinue the use of Bernard Madoff as a custodian for any of the company's securities and use only banks as custodians pursuant to s. 610.24, Wis. Stat.

The company also has custodial agreements with the following banks; BNY, AmSouth and two agreements with Chase Manhattan which all hold cash and securities in connection with repurchase agreements. The NAIC's Financial Condition Examiners Handbook lists certain safeguards that custodial agreements should contain. The aforementioned agreements did not contain several of these safeguards. It is recommended that all custodial agreements be amended to include provisions requiring:

- a) That the securities are at all times kept separate and apart from the other deposits with the custodian so that at all times they may be identified as belonging solely to SLH.
- b) That the trust company as custodian is obligated to indemnify the insurance company for any loss of securities of SLH occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.
- c) That in the event that there is a loss of the securities for which the trust company is obligated to indemnify SLH, the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.

**Common Stocks**

**\$51,926,590**

The above balance reflects an examination decrease of \$1,225,820. Under SSAP 46 (7) (b) (i), an insurance subsidiary of an insurance parent must be carried by the parent at the subsidiary's US statutory value (adjusted for unamortized goodwill permitted by SSAP 68). In order to verify the carrying value of Chaparral International Re (Chaparral), OCI would need SLH to file statutory basis annual statements and CPA audit reports for Chaparral with reconciliations to the SLH carrying value of Chaparral.

The examiners valued Chaparral at zero on a statutory basis because SLH was unable to provide the following:

- 1. A statutory annual statement for Chaparral for the prior year on the NAIC Association blank, with a Wisconsin statutory basis actuarial opinion and completed jurat page.
- 2. A US statutory basis CPA audited financial statement for Chaparral.

Since the company could not provide the above, the examiners reduced SLH's investment in SFC to reflect their reduction of the value of Chaparral to zero. It is recommended that SLH adjust its valuation of SFC to reduce the value of Chaparral to zero on future annual

statements, unless a higher value is supported by a statutory annual statement for Chaparral on the NAIC Association blank with a Wisconsin statutory basis actuarial opinion, a completed jurat page, and a US statutory basis CPA audit report for Chaparral pursuant to SSAP 46(7) (b) (i), and s. 601.42, Wis. Stat.

The examination made an adjustment to reduce SLH's surplus by the amount of SFC's investment in Chaparral. Due to the difficulty in determining Chaparral's value, which comprises most of SFC's value, the entire amount of SLH's investment in SFC of \$1,225,820 was adjusted. This adjustment is reflected in the section of this examination report titled "Reconciliation of Surplus per Examination."

### **Real Estate**

In 1997, SLH acquired an interest in a Connecticut building from Geneve Corporation (an affiliate) for \$2 million. The structure of the transaction was that SLH acquired the building, but not the land on which the building sits (the land is owned by an unaffiliated third party). SLH assumed Geneve Corporation's land lease commitment on the land (99 years at \$1 per year).

The substance of this transaction is that SLH acquired a land lease and leasehold improvements for \$2 million and capitalized them as a real estate investment. However, real estate investments are defined by SSAP 40 as directly-owned real estate properties. Pursuant to SSAP 22 all leases are operating leases for insurers, and do not qualify for capitalization. Under SSAP 19, leasehold improvements are non-admitted assets and should be charged to surplus.

The examination reduced surplus \$1,845,833 to non-admit the entire balance of the claimed real estate. It is recommended that the investment in leased real estate and improvements thereon be classified on Schedule BA as leasehold improvements and non-admitted pursuant to SSAP 19 paragraphs 4 and 5.

### **Other Invested Assets**

The company's ownership in the Dolphin Limited Partnership is classified by s. 620.22 (9), Wis. Stat., as an "investments not otherwise permitted by this section, and not specifically prohibited by statute, to the extent of not more than 5% of the first \$500,000,000 of the insurer's assets". The insurer's investment in excess of 5% of assets in such investments

may not be counted by the company in its calculation of compulsory surplus. At year-end 2002, the company reflected the value of the partnership on its filed annual statement at \$7,657,385. This exceeded 5% of the company's assets by \$303,175. The examination decreased compulsory and security surplus excesses by \$303,175. See the section in this examination report titled "Compulsory and Security Surplus Calculation" for the adjusted compulsory and security surplus excess amounts. It is recommended that in future compulsory and security surplus filings the company deduct investments described by s. 620.22 (9), Wis. Stat., that exceed 5% of the company's assets in its calculation of compulsory and security surplus, pursuant to s. 620.21, Wis. Stat.

**Reserves Receivable on Reinsurance Assumed** **\$1,712,369**

The examination decreased this asset \$1,711,000. This adjustment is reflected in the section of this examination report titled "Reconciliation of Surplus per Examination." Reinsurance reserve reports received from United Insurance Company of America contained a difference from SLH records for the 2001 beginning reserve. The company reported this difference of \$1,711,000 on its annual statement as a part of a write-in asset "Reserves Receivable on Reinsurance Assumed." The examination decreased surplus \$1,711,000 since the receivable was not sufficiently documented to qualify as an asset under SSAP 4.

**Commissions and Expense Allowances Payable on Reinsurance Assumed** **\$1,118,145**

The above balance reflects an examination decrease of \$391,000. Due to the examination adjustment to reserves receivable on reinsurance assumed, discussed above, the examination made a corresponding adjustment to the commission liability on reinsurance assumed. This adjustment is reflected in the section of this examination report titled "Reconciliation of Surplus per Examination."

**Reinsurance**

Settlement of the reinsurance balances with United Insurance Company of America are not being performed within the requirements of the reinsurance agreement. The reinsurance agreement, paragraph 12, states that reinstatement activity, death benefits, surrender activity and service fees be reported to SLH on or before the 30th day of each January, April, July, and

October for the preceding quarter. The examiner noted that the balance settled during August 2003, consisted of transactions from July 1, 2002 through June 30, 2003.

The companies should be aware of the provisions of s. Ins 55.02 (1) (h), Wis. Adm. Code. This rule prohibits the ceding company from reducing reserves for reinsurance if settlements are made less frequently than quarterly, or if payments due from the reinsurer are not made within 90 days of the settlement date. While this rule does not directly impact SLH as the assuming company, it may be in the best interest of the companies to settle the contract quarterly. It is recommended the company settle reinsurance balances in accordance with the provisions of the reinsurance agreement.

## **VIII. CONCLUSION**

This examination resulted in four adjustments to surplus. These were adjustments to reserves receivable on reinsurance assumed, commissions and expense allowances payable on reinsurance assumed, real estate, and the value of the common stock of Southern Financial Corporation. The company complied with four of the five prior examination recommendations. The recommendation concerning properly filing Form B is being repeated.

This examination also made recommendations on improving information technology controls, reporting of affiliated transactions, properly reporting items on the annual statement, custodial agreements, valuation of an off-shore subsidiary, reporting of real estate, compulsory and security surplus calculations, recognition of and settlement of reinsurance balances.

The company's surplus and admitted assets have increased each year under the examination with the exception of 2002 in which SLH paid a dividend of \$5,002,000. Gross direct and assumed life insurance in-force as well as net life insurance in-force increased each year under the examination. This is reasonable given SLH did not write any new direct business during the period under review and the assumption of paid-up and extended term business.

## IX. SUMMARY OF COMMENTS AND RECOMMENDATIONS

1. Page 24 - Information Technology Controls—It is recommended that the company secure its file server and distribution equipment, by installing and maintaining locked access to the fileserver room.
2. Page 24 - Information Technology Controls—It is recommended that the company initiate system and/or application changes that force all passwords to be changed at least quarterly.
3. Page 24 - Information Technology Controls—It is recommended that the company establish inventory control on its blank check stock, including maintaining a locked cabinet in which to keep the check stock.
4. Page 24 - Information Technology Controls—It is recommended that the company develop emergency response procedures that at a minimum include a checklist of the procedures to follow, and the resources to contact, in the event of a computer security incident.
5. Page 24 - Affiliated Companies—It is recommended that the company develop and execute agreements, that clearly and accurately disclose the nature and details of all the various transactions amongst affiliates for all services provided and for settlement of any outstanding balances, pursuant to s. 611.61, Wis. Stat.
6. Page 25 - Affiliated Companies—It is again recommended that in future Form B filings, the company include a description of all agreements with affiliates as required by s. Ins 40.15, Wis. Adm. Code.
7. Page 25 - Affiliated Companies—It is recommended that the company fully comply with s. Ins 40.02, Wis. Adm. Code, and s. 617.11(1), Wis. Stat., in the future.
8. Page 26 - Affiliated Companies—It is recommended that the company file a Form D for all affiliated transactions which are equal to or exceed the lesser of two percent of the insurer's admitted assets or 10% percent of policyholder surplus, at least 30 days prior to entering into the transaction pursuant to s. Ins 40.04 (2) (a), Wis. Adm. Code.
9. Page 26 - Affiliated Companies—is recommended that, in the future, the company report all affiliated partnerships on Form B as required by s. Ins 40.03 (3) (c) (1), Wis. Adm. Code.
10. Page 27 - Affiliated Companies—It is recommended the company properly complete Column 8 of Schedule Y, according to the NAIC Annual Statement Instructions – Life, Accident and Health by properly including all revenues and expenditures under management and service agreements.
11. Page 27 - Accounts and Records—It is recommended the company report all entities which are included in its consolidated federal income tax return in Note 9 F of future Annual Statements in accordance with the NAIC Annual Statement Instructions – Life, Accident and Health.
12. Page 27 - Bonds—It is recommended that the insurer disclose its private placement bond holdings in Schedule D - Part 1A, as required by the NAIC Annual Statement Instructions – Life, Accident and Health.

13. Page 27 Custodial Agreements—It is recommended that the company discontinue the use of Bernard Madoff as a custodian for any of the company's securities and use only banks as custodians pursuant to s. 610.24, Wis. Stat.
14. Page 28 - Custodial Agreements—It is recommended that all custodial agreements be amended to include provisions requiring:
- a) That the securities are at all times kept separate and apart from the other deposits with the custodian so that at all times they may be identified as belonging solely to SLH.
  - b) That the trust company as custodian is obligated to indemnify the insurance company for any loss of securities of SLH occasioned by the negligence or dishonesty of the trust company's officers or employees, or burglary, robbery, holdup, theft, or mysterious disappearance, including loss by damage or destruction.
  - c) That in the event that there is a loss of the securities for which the trust company is obligated to indemnify SLH, the securities or the value of the securities and the value of any loss of rights or privileges resulting from said loss of securities shall be promptly replaced.
15. Page 28 - Common Stocks—It is recommended that SLH adjust its valuation of SFC to reduce the value of Chaparral to zero on future annual statements, unless a higher value is supported by a statutory annual statement for Chaparral on the NAIC Association blank with a Wisconsin statutory basis actuarial opinion, a completed jurat page, and a US statutory basis CPA audit report for Chaparral pursuant to SSAP 46(7) (b) (i), and s. 601.42, Wis. Stat.
16. Page 29 - Real Estate—It is recommended that the investment in leased real estate and improvements thereon be classified on Schedule BA as leasehold improvements and non-admitted pursuant to SSAP 19 paragraphs 4 and 5.
17. Page 30 - Other Invested Assets—It is recommended that in future compulsory and security surplus filings the company deduct investments described by s. 620.22 (9), Wis. Stat., that exceed 5% of the company's assets in its calculation of compulsory and security surplus, pursuant to s. 620.21, Wis. Stat.
18. Page 31 - Reinsurance—It is recommended the company settle reinsurance balances in accordance with the provisions of the reinsurance agreement.

## **X. ACKNOWLEDGMENT**

The courtesy and cooperation extended during the course of the examination by the officers and employees of the company are acknowledged.

In addition to the undersigned, the following representatives of the Office of the Commissioner of Insurance (OCI), State of Wisconsin, participated in the examination:

<b>Name</b>	<b>Title</b>
Rebecca L. Easland	Insurance Financial Examiner
Bill C. Genne	Insurance Financial Examiner
Cruz J. Flores	Insurance Financial Examiner - Advanced
Jerry C. DeArmond	Insurance Financial Examiner - Advanced

Respectfully submitted,

Kerri Lee Miller  
Examiner-in-Charge